68-SBE-017

BEFORE THE 'STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ROBERT AND PATRICIA NEUSCHOTZ)

Appearances:

For Appellants: David Uzel
Certified Public Accountant

For Respondent: Gary Paul Kane
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of 'the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert and Patricia Neuschotz against a proposed assessment of additional personal income tax in the amount of $8,984.59 for the year 1961.

Appellants Robert Neuschotz and his wife Patricia are California residents; Patricia Neuschotz, her brother, and her sister, each own one-third interests in various parcels of real estate in the Borough of Queens, New York. Some of these parcels are operated in partnership, others in Corporate form. The entire real estate enterprise is managed by Mrs. Neuschotz's brother, a New York resident. A common bank account is maintained for business purposes in New York City.

In 1961 appellants received income totalling $184,200.32 from this real estate enterprise. The sale of seven apartment houses, each held by a separate corporation, and distribution of the proceeds to Patricia Neuschotz, her brother and her sister, accounted for $155,304.11 of this amount. Another corporate transaction yielded $646.52 for appellants. The Neuschotzes also received $16,804.18 of installment income. They have stated that this sum had its source in one of the enterprise's partnerships. At the hearing of this matter respondent accepted this statement

as fact, and this concession will be reflected in our order. The remaining $11,445.51 of the above total was similarly generated by partnership activities of the enterprise. Appellants* share of business expenses was $41,090.62. No information is available concerning how much of this expense total was incurred by partnership operations. For the year 1961 appellants claimed a credit of $8,984.59 on their California return for income tax paid to the State of New York. Respondent has denied the full amount of this credit on the grounds that the income from the corporations did not have its source in New York, and that the amount of expenses incurred by partnership activity was unknown.

Section 18001 of the Revenue and Taxation Code gives residents a credit for net income taxes paid to another state on income derived from sources within that state. It is well settled that income received by a shareholder from a corporation has its source in the stock of the shareholder. (Miller v. McColgan, 17 Cal, 2d 432 [110 P.2d 419].) The situs of the stock and therefore the ultimate source of the income is the state where the shareholder resides. (Miller v. McColgan, supra.) However the stock can acquire a business situs in a state other than the residence of the owner, Hence, the source of the income would be in this new situs state, Whether appellants* stock acquired such a business situs in New York is the first issue of this case. Regulation 17951-17954(f), subdivision (3), title 18, California Administrative Code, provides some general definition of this concept:

> Intangible personal property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in connection with a business, trade or profession in this State so that its substantial use and value attach to and become an asset of the business, trade or profession in this State. For example, if a nonresident pledges stocks, bonds or other-intangible personal property in California as security for the payment of indebtedness, taxes, etc,, incurred in connection with a business in this 'State, the property has a business situs here., Again, if a nonresident maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State, the bank account has a business situs here.

Although this regulationis concerned with the source of nonresidents' gross income, and is stated in terms of a business situs in California, the general concept of business situs is equally applicable to the instant case.

Appellants state that their New York interests, whether in corporate or partnership form, were operated, along with the interests of Mrs. Neuschotz's brother and sister, as one large enterprise. They claim that the shares of stock were not isolated intangibles. Rather the corporations represented by these shares were integral parts of the entire real estate operation and were simply instrumentalities through which a part of the entire business was conducted,, Appellants state that these corporations were managed by a New York resident, They contend that the above circumstances are sufficient to establish a New York business situs for their stock.

We cannot agree with this contention. The. concept of business situs involves localization of the intangible property itself in the business situs state as an asset of a business there. In the instant case there is no evidence of localization of appellants' stock in New York, The certificates were in the possession of appellants in California. The stock was not used in connection with the Neuschotzes' other New York business interests. The fact that appellants owned similar interests in New York and that all these interests were managed as one enterprise does not demonstrate localization of the intangible property in that state. Nor does the management of the corporations by a New York resident satisfy this requirement. The intangible shares of stock are the relevant property here, not the corporations and their assets,

We conclude that appellants* stock did not acquire a business situs in New York. The situs remained in California, the residence of the Neuschoties. Consequently the income received by appellants from this stock had its source in California, and New York taxes paid on it will not serve as a basis for a credit under section 18001.

The next question presented is whether a credit can be given for New. York income tax paid on appellants* share of income generated by partnership activities .in that state. In order to compute the credit under section 18001, it is necessary to know the adjusted gross income which in turn requires knowledge of the business expenses allocable .to the gross income. (See Appeal of John H. and Olivia A. Poole, Cal, St. Bd. of Equal., Oct. 1, 1963.) Appellants' share of expenses from the entire real estate business was $41,090.62. However, no information is available concerning what proportion of this amount was attributable to appellants* partnership interests.

The issue posed is whether under these circumstances a credit can be allowed for the New York tax paid by appellants on the income derived from this partnership activity.

Respondent argues that appellants must prove the amount of expenses incurred in earning this partnership income and, if they cannot, then no credit is permissible. However, the tax law makes allowance for approximations when the exact amount of expenses is unknown. (Cohan v. Commissioner, 39 F.2d 540.) A situation similar to the instant case arose in Edward Mallinckrodt, Jr., 2 T.C. 1128, where the taxpayer only knew the total of his expenses incurred in managing his investment business which produced both taxable and nontaxable income. The court stated at page 1148:

> Since the parties submitted no evidence bearing directly on the question as to what portion of the expenditures should be allocated to nontaxable income, and in the absence of evidence indicating what would constitute a more reasonable basis for such allocation, we hold such expenditures for the respective years are to be allocated to taxable income and nontaxable income of such years in the proportion that each bears to the total of the taxable and nontaxable income of the petitioner for such years.

We believe the same method of allocation would be appropriate in the instant case. Accordingly, expenses should be allocated to the partnership income in the same proportion as partnership income bears to the total income from the real estate enterprise.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Robert and Patricia Neuschotz, against a proposed assessment of additional personal income tax in the amount of $8,984.59 for the year 1961, be and the same is hereby modified by determining appellants' expenses allocable to partnership income in the manner specified in the opinion, and in accordance with respondent's concession that installment income in the amount of $16,804.18 had its source in partnership activity,

In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 25th day of March, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary